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MICHAEL RODAK, JR.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

No. .....

SOL BERGER,

Petitioner,

—against—

UNITED STATES OF AMERICA.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

GEORGE G. GALLANTZ
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PROSKAUER ROSE GOETZ & MENDELSOHN

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Sol Berger petitions for a writ of certiorari to review a judgment of the United States Court of Appeals for the Second Circuit entered March 20, 1972 affirming petitioner's conviction by a District Judge, sitting without a jury, of attempting to evade the United States corporate income tax obligations of Colonial Corporation of America. A jail sentence was imposed by the District Court. Rehearing was denied by the Court of Appeals on April 20, 1972.

Opinions of the Courts Below

The opinion of the Court of Appeals appears beginning at page A. 1 of the Appendix to this petition. The opinion of the District Court for the Southern District of New York is reported at 325 F. Supp. 1297 (1971) and is reprinted beginning at page A. 10 of the Appendix.

Jurisdiction

The judgment of the United States Court of Appeals (A. 7)* was entered on March 20, 1972, affirming petitioner's conviction dated June 4, 1971. The Court of Appeals denied a timely petition for rehearing on April 20, 1972 (A. 9). Jurisdiction in this Court is invoked under 28 U.S.C. §1254(1).

Questions Presented

1. In a criminal prosecution against a former officer of a "controlled taxpayer" (as defined in Section 482 of the Internal Revenue Code), in which the Government undertook to prove beyond a reasonable doubt that the manner in which the taxpayer reported transactions with a subsidiary gave rise to tax deficiencies, was the defendant (petitioner here) entitled to the application of the Section 482 standards that would have had to be applied in a civil tax case involving the taxpayer?

2. Where the underlying facts found by the trial court were inconsistent with the conclusion that petitioner's acts affected the taxable income of the taxpayer, did the Court below err in affirming the finding that petitioner acted with intent to evade corporate income tax?

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* The designation "A." refers to the Appendix to this petition. The designation "R." refers to the Joint Appendix in the Court of Appeals.

Statute Involved

Section 482 of the Internal Revenue Code of 1954, as amended, and Treasury Regulation §1.482-1 (1962, as amended, 1968), and excerpts from Treasury Regulation §1.482-2 (1968, as amended, 1969, 1972), appear beginning at pages A. 29 and A. 41, respectively, of the Appendix.

Statement of the Case

Petitioner was convicted of attempting to evade the United States corporate income tax obligations of Colonial Corporation of America ("Colonial") for the years 1962, 1963 and 1964. In those years, Colonial was a publicly-held corporation engaged in the manufacture and sale of wearing apparel and was subject to United States corporate income tax. Petitioner was Colonial's chief executive officer and he and his family owned a substantial bloc of the corporation's stock.

Colonial Shirts of Jamaica, Ltd. ("Jamaica"), a wholly-owned subsidiary of Colonial, manufactured shirts in Jamaica and sold its entire output to Colonial. Jamaica was exempt from United States income tax and was accorded favorable tax treatment under Jamaican law.

Colonial's purchase of Jamaica's production subjected Colonial to an import duty calculated as a percentage of the price invoiced by Jamaica to Colonial ("the invoice price") (R. 472-73). Because Colonial and Jamaica did not deal at arm's length, customs regulations required Colonial to substantiate, through cost figures, the reasonableness of the invoice price (R. 463, 490-91, 19 U.S.C.A. §§1401a, 1503 (1965)). In order to minimize customs duties, Colonial's

financial vice-president, Leonard Friedman, presented to customs officials unrealistically low cost figures which did not reflect actual costs being incurred by Jamaica (R. 524, 577, 653-4, 661). The resulting invoice price, which purportedly included a profit to Jamaica, in fact was less than Jamaica's actual cost. (Compare R. 1721-26 with R. 1820-25.)

To preserve the benefits of the low invoice price, and at the same time avoid an unreasonably high taxable profit to Colonial on its resale of Jamaica's products, Colonial adopted the practice of supplementing its payment of Jamaica's invoices by satisfying part of Jamaica's obligations to its suppliers of piece goods (fabric) and trim (buttons, labels, etc.) (R. 1214-23, 1263, 1333). In its tax returns, Colonial deducted as its cost the amounts paid by it against Jamaica's invoices and the amounts paid by it to Jamaica's suppliers (R. 755-56).*

Petitioner's conviction rests upon holdings that Colonial's supplemental payments to Jamaica's suppliers were not deductible by Colonial, that petitioner caused the supplemental payments to be made for the purpose of reducing Colonial's tax obligations, and that he did so with criminal intent.

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* To illustrate, assume that Colonial paid Jamaica $5 per dozen shirts against invoices in that amount and paid an additional $1 per dozen to Jamaica's suppliers. In its tax returns, Colonial reported $6 as its cost, i.e., the sum of the $5 and $1 payments.

REASONS FOR GRANTING THE WRIT

Petitioner Was Deprived of the Protection Which Would Have Been Accorded the Taxpayer in a Civil Proceeding.

This case presents a question of first impression concerning the interpretation and application of Section 482 of the Internal Revenue Code and its availability to taxpayers and defendants in criminal cases.

While the Section and its Regulations give the District Director the authority to reallocate income and expenses of commonly-controlled taxable entities to prevent the arbitrary shifting of income, the Regulations restrict the exercise of this authority to cases in which the commonly-controlled entities have not dealt with each other at arm's length. The protection thus afforded taxpayers, the provision of "safe havens" prohibiting unwarranted reallocations by the Internal Revenue Service, was denied to petitioner in this case—apparently for the very reason that it is a criminal case.

Fundamental to petitioner's conviction was the determination that the tax returns of Colonial included the deduction of costs properly attributable to a subsidiary. Had that question been raised in a civil tax proceeding, the propriety of the deductions taken by Colonial would have been determined through the application of the standards established under Section 482 of the Internal Revenue Code and the Regulations promulgated thereunder.

Throughout the trial, the Government persisted in its view that Section 482 was inapplicable and that it had no burden to prove that Colonial had violated the standards of the Section 482 Regulations. Petitioner, while in-

sisting that no conviction could stand unless the prosecution proved such a violation beyond a reasonable doubt, nevertheless offered affirmative proof that Colonial had in fact met the statutory standards. His defense was frustrated by the trial court's refusal to hear the proof. On appeal, although the exclusionary rulings were fully briefed and argued by both sides, the Court below ignored the point.

The Purpose of Section 482 and Its Protection of Taxpayers

Section 482 of the 1954 Code, and its predecessor sections under earlier Codes, were enacted to permit the District Director "to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income . . . of a controlled taxpayer" (Treas. Reg. §1.482-1(b)(1), A. 30).

The detailed Regulations, which prescribe the tests for determining whether controlled taxpayers have dealt with each other at arm's length, create what have been officially characterized as "safe havens" for taxpayers. So long as the transactions between the controlled taxpayers meet these standards, they are immune from attack.

The Treasury Releases which announced the promulgation of the Regulations, and Treasury officials in explanatory articles, repeatedly emphasized that the Regulations provided "safe havens" or "prima facie rules" to protect taxpayers against unwarranted reallocations and to provide guidance with respect to the manner in which transactions could be carried out with reasonable confidence that audit would not result in reallocations under Section 482.

Thus, when the current Section 482 regulations were adopted, the Treasury stated:

> "The plan of the regulations is to describe the application of the arm's length standard generally and then to detail its application in five specific types of transactions. In each of these specific cases the general rule is first stated—that is, that the proper arm's length consideration will be determined with reference to all surrounding facts and circumstances. Next, in some instances, a safe haven or prima facie rule is provided. *The safe haven or prima facie rule provides a specific rate or charge that will be accepted as arm's length unless the taxpayer (and not the Government) desires to establish a more appropriate rate.*" Treasury Dep't Release F-1217, 7 CCH 1968 *Stand. Fed. Tax Rep.* ¶6740 (April 16, 1968). (Emphasis added.)

Throughout the period the regulations were being formulated, the Treasury repeatedly stated to the public and the tax bar that the regulations were intended as a guide to taxpayers so that they might carry out transactions "without concern that they will later have their income and their tax liability increased as a result of Section 482 allocations." (Treasury Dep't Release, 7 CCH 1965 *Stand. Fed. Tax Rep.* ¶6522 (March 31, 1965)). *See also* Treasury Dep't Release F-559, 7 CCH 1966 *Stand. Fed. Tax Rep.* ¶6685 (August 2, 1966).

To the same effect, *see* Cohen (then Commissioner of Internal Revenue), "How the IRS Intends to Administer the New Regulations Under Section 482", 28 *J. Tax.* 73 (1968); and Surrey (then Assistant Secretary of the Treasury for Tax Policy), "Treasury's Need to Curb Tax Avoidance in Foreign Business Through Use of 482", 28 *J. Tax.* 75 (1968).

These published statements announced a clear policy that the District Director may not, even in a civil case, disallow a portion of the purchase price paid by one member of a controlled group to another if that price is an arm's length price within the meaning of Section 482.

It is these "safe havens"—the arm's length tests spelled out in the Regulations—which would have been available to Colonial in a civil tax proceeding but were denied to this petitioner. Here, because the Court below waved Section 482 aside as inapplicable, the Government was not required to prove that Colonial paid Jamaica more than an arm's length price and petitioner was not permitted to prove that the transactions were within the "safe havens" established by the Regulations.

The Evils Against Which the Section Is Directed

Transactions between controlled taxpayers are scrutinized "to ascertain whether the common control is being used to reduce, avoid, or escape taxes" (Treas. Reg. §1.482-1(c), A. 32). "Section 482 authorizes the allocation of income and deductions between related entities to prevent the evasion of taxes by shifting of profits, the making of fictitious sales, and other methods usually used to 'milk' a taxable entity" (*PPG Industries, Inc.*, 55 T.C. 928, 990-91 (1970)).

This is precisely what the Government claimed, and what the courts below found, occurred here. In its brief to the Court of Appeals, the Government characterized Colonial's payment of Jamaica's obligations and its deduction of those payments as part of its cost as "a simple manipulation of book entries . . . to reduce Colonial's taxable income . . . while at the same time increasing Jamaica's untaxed profits by the same amount" (Govt. Br., p. 11).

The Court below termed the transactions a "system by a parent corporation to make payments to the creditors of its subsidiary . . . in order to increase the already significant tax free profits which that subsidiary could have expected . . ." (A. 5).

The nature of the transactions, the purchase or sale of goods between a United States corporation and a subsidiary exempt from tax, is in the classic model for a reallocation of costs under Section 482. See *American Terrazzo Strip Co.*, 56 T.C. 961 (1971) (sales by foreign corporations to commonly-controlled domestic corporations); *United States Gypsum Co.* v. *United States*, 71-2 U.S. Tax Cas. ¶9706 (7th Cir. 1971) (sales by Western Hemisphere Trade Corporation subsidiary to domestic parent); *Lufkin Foundry and Machine Co.*, 30 C.C.H. Tax Ct. Mem. 400 (1971) (commissions paid and discounts allowed by domestic parent to Western Hemisphere Trade Corporation subsidiary); *PPG Industries, Inc.*, 55 T.C. 928 (1970) (sales by foreign subsidiaries to domestic parent); and *Baldwin-Lima-Hamilton Corp.* v. *United States*, 435 F.2d 182 (7th Cir. 1970) (sales by domestic parent to Western Hemisphere Trade Corporation subsidiary). See also, the many examples, using similar transactions, contained in Treas. Reg. §1.482-2.

Thus, while the evil found to exist is the very evil against which Section 482 was directed, and the disputed transactions were of the sort typically scrutinized under that Section, the Court below held, without a word of supporting reasoning, that Section 482 "does not pertain to the case at bar" (A. 5).

In other words, the right to establish that the challenged transactions met the standards of the Section 482 Regulations, available to any taxpayer, including Colonial, in a

civil proceeding, was not available to petitioner in this criminal prosecution.

The Rejection of Section 482

The unsupported statement of the Court below, made in a footnote, that Section 482 "does not pertain to the case at bar" was based upon an erroneous view of the transactions and an erroneous interpretation of the Regulations and their application to this proceeding.

The decisions below rest upon the treatment of Colonial's supplemental payments to Jamaica's suppliers as being of a different character from Colonial's payments against Jamaica's invoices. Apparently, these payments were held non-deductible merely because they were made indirectly and satisfied Jamaica's obligations for some of the raw materials of its manufacturing process.

These supplemental payments cannot have been rendered non-deductible merely because they were made indirectly. The proposition that a buyer, who satisfies an obligation of a seller to a third party, has made a payment to the seller is not merely logically clear, but specifically recognized in the Internal Revenue Code itself (Section 61(a)(12); *see, Old Colony Trust Co.* v. *Commissioner,* 279 U.S. 716, 729 (1929)).

That the fabric and trim paid for by Colonial were "routine manufacturing expenses of Jamaica" (A. 5) has no bearing on the fact that, by paying those bills, Colonial was making an additional payment for the goods it purchased from Jamaica. If petitioner had purchased a suit from a retail merchant and paid for it by paying the merchant's telephone bill of $150, would not petitioner's cost be $150? That the telephone bill was a necessary

expense of the clothier would have no bearing on the economic fact that defendant paid $150 for his suit.

The trial court applied the "ordinary and necessary" test by which a business expense is judged under Section 162 of the Code (A. 15, 17-18), and the Court below stated that the indirect payments were not "necessary to the continued existence" of Colonial (A. 5).

Even under this test, it would have been the Government's obligation to prove beyond a reasonable doubt that Colonial's payments were not ordinary and necessary expenses of its business. Colonial's business, in this context, was the purchase of finished shirts and the resale of those goods to others. Surely, any amounts paid by Colonial for those goods, necessary to its continued existence as a seller of finished shirts, constituted ordinary and necessary expenses of its business.

Moreover, the District Court found that the supplemental payments *were* part of Colonial's cost for the goods. It found as a fact that if Colonial had not made these payments to Jamaica's suppliers, Jamaica would have increased its invoice prices to Colonial by the equivalent amounts, resulting in the same total cost (A. 16).

Colonial having actually paid the total amounts deducted by it, and it having been established that those payments represented Colonial's cost for the goods, the only conceivable basis on which the Government could disallow any portion of that deduction would be that the amount paid exceeded the arm's length price of the goods and that Colonial, in paying that excess, was diverting income to a subsidiary exempt from tax. That is to say, a reallocation of costs and income under Section 482.

The only basis given by the Court below for concluding that Section 482 "does not pertain to the case at bar." was the citation: "See 26 C.F.R. §1.482-1(b)" (A. 5). The Regulation does, of course, say that "Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions" (A. 31).

But it is the Regulation cited by the Court below that does not pertain to the case at bar. It was adopted for the purpose of eliminating a provision in a predecessor of Section 482 which had granted to taxpayers the right to compel the District Director to treat separately-filed returns on a consolidated basis. Revenue Act of June 2, 1924, ch. 234, 43 Stat. 253; Revenue Act of February 26, 1926, ch. 27, 44 Stat. 9. See I.T. 2151, IV-1 CUM. BULL. 53 (1925); *Connery Coal & Investment Co.* v. *Commissioner,* 84 F.2d 485 (7th Cir., 1936). It has also been applied to prevent a taxpayer from filing amended returns in which inter-company transactions were adjusted to reflect arm's length values. *Interstate Fire Insurance Co.* v. *United States,* 215 F. Supp. 586 (E.D. Tenn. 1963), *aff'd per curiam,* 339 F.2d 603 (6th Cir., 1964); see also, *First Securities Corporation of Memphis* v. *Clements,* 39-2 U.S. Tax Cas. ¶9607 (M.D. Tenn. 1937), *aff'd per curiam,* 103 F.2d 1011 (6th Cir., 1939).

Here, petitioner did not seek the consolidation of separately-filed returns nor any adjustment of Colonial's returns as filed. He sought no reallocation, no reclassification, no alteration of any item in Colonial's returns. Both the trial court and the Court below were somehow misled into believing that petitioner was seeking to restructure the transactions, to reallocate in reliance on Section 482. The Government called black white and

white black and succeeded in standing the statute on its head.

To repeat, it was not petitioner who was seeking a change in the returns as filed, or a different allocation of income or expenses. It was the Government, not petitioner, which was restructuring the tax returns, recasting the income statements, reallocating the costs, disallowing sums concededly spent by Colonial and deducted on its returns.

Petitioner's invocation of Section 482 was purely defensive. He insisted that in a criminal prosecution the Government must prove, under the tests laid down by the Section 482 Regulations, that the total amounts paid by Colonial exceeded the arm's length price for the goods. Only upon such proof of a deficiency in the taxes paid by Colonial could the Government claim error in the tax returns, and prosecute criminally. The Court below, in simply dismissing the Section as irrelevant in a one-sentence footnote, revealed no understanding of petitioner's purpose in invoking it.

Erroneous and Prejudicial Exclusion of Evidence Proffered by Petitioner

The District Director may allocate deductions among commonly-controlled corporations where necessary to reflect clearly the true income of such corporations (Treas. Reg. §1.482-1(b)(1), A. 30-31). True income is defined as the income which would have resulted to the controlled taxpayer had it dealt with the other member of the controlled group at arm's length (Treas. Reg. §1.482-1(a)(6), A. 30). Here, the question was whether Colonial paid Jamaica more than the arm's length price for the goods and thereby diverted income to a subsidiary exempt from tax.

The Regulations specify in great detail the manner in which arm's length values are to be determined (Treas. Reg. §1.482-2, A. 41-60), yet the Government made no attempt to establish that the total price paid by Colonial exceeded the arm's length price of the goods and petitioner's proffered evidence on the point was excluded.

Petitioner offered to prove that the total amounts paid by Colonial approximated the aggregate arm's length price of the goods and that the gross profits earned by Colonial and Jamaica were equivalent to those being earned by other companies in the uncontrolled sale and resale of similar products (R. 1080-94, 1097-1100, 1184-88). This evidence was excluded by the trial court, which viewed transactions by unrelated companies as having no relevance to the issues at bar (R. 1087, 1186).

Although the prejudice to petitioner caused by this erroneous ruling was fully argued to the Court below, the point was not considered or even mentioned in its opinion. In finding the invoice price (the $5 element of the $6 cost) to be not "unrealistic" (A. 3), the Court of Appeals made no reference to the exclusion of proof on this very issue, ignored the finding of the District Court that the invoice price was "low" (A. 15), and applied none of the tests established under the Regulations.

The determination of the Court below apparently rested on the comparative net profit ratios of Colonial and Jamaica (A. 3, 4). In no case are net profit ratios relevant factors under the Regulations. In some circumstances *gross* profit ratios may be relevant, but then only in connection with the *uncontrolled* sale or resale of similar products (Treas. Reg. §1.482-2(e)(3), (4), A. 50, 57). The Court below also considered of importance that the customs agents had accepted the invoice price (A. 2, 3), despite the

uncontradicted testimony of Government witnesses that the costs reflected in the invoice price were intentionally understated by Colonial (see pp. 3-4 *supra*). Moreover, the Regulations explicitly reject, as a test of arm's length price, the price established by contract between members of a controlled group (Treas. Reg. §1.482-1(a)(6), A. 30).

On the record made at trial, consideration of the Section 482 Regulations, in view of the Government's burden to prove every element of the indictment beyond a reasonable doubt, would have mandated a finding that no tax deficiency had been proven and that the indictment must be dismissed. Even if the Government had made out a case in a manner consistent with the Regulations, the exclusion of the evidence tendered by petitioner would require reversal and a new trial.

The Rejection of Civil Standards

In its brief below, the Government urged the rejection of the many authorities cited by petitioner in support of the deductions, characterizing them as "*civil* cases which are completely irrelevant to this *criminal* prosecution" (Govt. Br., p. 20, emphasis supplied). The adoption of this argument by the Court of Appeals is implicit in its discussion of those authorities and its rejection, in a one-sentence footnote, of Section 482.

In an era which has seen an unprecedented expansion of constitutional rights afforded to defendants in all manner of criminal cases, it is to say the least shocking that, in this case, the Court of Appeals has held that the standards applied in civil tax cases and the protection afforded by a civil tax statute are wholly irrelevant to the determination of a tax deficiency in a criminal tax prosecution.

Petitioner's Conviction Rests on Findings of Fact Which Themselves Negate Any Possibility of Criminal Intent.

The trial court found that if Colonial had not satisfied some of Jamaica's obligations to its suppliers, Jamaica would have paid those obligations directly and would have increased its prices to Colonial to take account of its additional costs.

> "The simple fact is that had all the piece goods and raw materials invoiced to Jamaica by foreign vendors and others . . . been entered on the books of Jamaica as its cost of production, *an increase in the constructed price charged to Colonial would have been required* . . . '(t)he only alternative to the adjustments would have been to charge the Jamaican subsidiaries for the full amount of purchases and supplies and in turn to have *increased the amount of the billings to the parent from the Jamaican subsidiaries by an equivalent amount.*'" (A. 16, emphasis supplied.)

In other words, to revert to our hypothetical example (ftn. *supra,* p. 4), if Colonial had not paid $1 per dozen to Jamaica's suppliers, Jamaica would have paid that $1 and increased its invoice price per dozen from $5 to $6. The conclusion is self-evident that the *manner of payment* had no effect upon the income of either Colonial or Jamaica. Regardless how it made payment, Colonial's cost would be $6 per dozen and it and Jamaica would have had precisely the same amount of income.

Neither the trial court nor the Court below seemed to perceive this simple proposition. The trial court's conclusions that this change in the *manner* of payment would

have affected "the income picture of both corporations" and that the indirect payments "reduced Colonial's taxable income" (A. 13, 16) were logically unsound and mathematically incorrect. The statement of the Court below that Colonial paid Jamaica $6 in two elements "in order to manipulate Colonial's profits" (A. 4) evinces a similar misconception.

There was no manipulation of Colonial's profits and no effect upon Colonial's income or that of Jamaica. Whether Colonial paid Jamaica $6 against its invoices, or $5 against invoices and $1 indirectly, the figures on Colonial's tax returns would remain unchanged. It necessarily follows that the decision, attributed to petitioner, to cause Colonial to pay Jamaica in two elements could not have been motivated by any desire to reduce or in any way affect Colonial's tax obligations.

Concededly, the amount invoiced by Jamaica affected the amount of customs duty paid by Colonial; the lower the invoice price, the lower the customs duty. The evidence made it clear that this, the desire to minimize customs duties, was the motivation for paying Jamaica in two elements. The Government conceded this: " . . . the so-called low price [$5 in our example] was the product of a conscious decision by Colonial's management to reduce customs duties . . . " (Govt. Br., pp. 21, 25).

Petitioner had no part in the establishment of the invoice price for customs purposes; the Government's witnesses so testified (R. 471, 542) and the trial court so found (A. 14-15). Except as the explanation for Colonial's paying Jamaica in two elements rather than one, customs duties had no place in the determination of this case. The only relevant question was whether petitioner intended to evade corporate income taxes. The established facts proved that

he could not have had such motivation because his acts had no effect on Colonial's taxable income.

When this argument was made in the Court below, the Government made no attempt to answer it but dismissed it with the word "hypothetical" (Govt. Br., p. 29). The Court adopted that terminology, characterizing petitioner's argument as "hypothetical restructuring of the taxable transaction" (A. 3), thus demonstrating a total misapprehension of the argument. Both the trial court and the Court of Appeals apparently believed petitioner to be arguing that the tax returns of Colonial should be treated *as though* Jamaica had billed Colonial $6 per dozen shirts.

Petitioner never asked the Court to make a determination based on what might have been done. On the issue whether additional tax was due he rested upon the returns as filed. He did contend that, to determine whether he acted with criminal intent, whether the manner in which the transactions were actually reported was motivated by tax considerations, the Court must look at the manner in which the transactions would have otherwise been reported. To put it differently, if what should have been done under the Government's theory would have resulted in precisely the same deduction as what was done, then what was done could not have been motivated by the desire to evade taxes.

The Government conceded that Colonial could have achieved the same result by having Jamaica invoice Colonial $6 per dozen (Govt. Br., p. 24). If Colonial would have been entitled to deduct the entire $6 payment had that been the invoice price, then reducing the invoice price to $5 and paying an additional $1 indirectly could not have resulted in any greater deduction and therefore could not have been motivated by any desire to evade tax.

The authorities relied on by the Court below are further proof that it misconceived petitioner's position. In *United States* v. *Campbell,* 351 F.2d 336 (2d Cir. 1965), defendant failed to report large amounts of capital gains income in his tax returns. He justified the exclusion on the basis that he was a resident of Canada, but failed to disclose the income to Canadian taxing authorities. He asked the court to rewrite his tax returns as if he had reported his capital gains, had paid a Canadian tax and had taken a credit against United States tax for the Canadian tax paid. This, the court refused to do. In *United States* v. *Vardine,* 305 F.2d 60 (2d Cir. 1962), the defendant failed to report taxable income in his returns. He argued that if he had maintained his books on the accrual method, he would have been able to offset expenses against the unreported income. The court refused to permit him thus to restructure the filed returns.

Here, Colonial reported and deducted the entire amount of its payments to Jamaica, direct and indirect. Petitioner did not ask the Court to change a single figure in those tax returns. The returns reflected payment to Jamaica, in our hypothetical example, of $6 per dozen shirts and petitioner in no way sought to alter that transaction. Cases like *Campbell* and *Vardine* are therefore entirely inapposite.

To belabor the obvious, petitioner's position was simply this: so long as Colonial actually paid $6 per dozen for the shirts, it made no difference to its taxable income how that payment was made. The method of payment could not have been motivated by any intent or desire to affect Colonial's taxable income and the finding that petitioner caused Colonial to pay Jamaica in two elements with the criminal intent of evading Colonial's tax obligations was contradicted by the established facts found by the trial court.

Thus, in affirming petitioner's conviction, the Court of Appeals eliminated as an essential element of the crime charged the intent to evade the payment of tax.

CONCLUSION

This case presents this Court with its first opportunity to deal with the important Congressional policy enunciated in Section 482 of the Internal Revenue Code which affects the thousands of taxpayers who are members of controlled groups, and who regularly do business with each other. The holding below, that the Section and the Regulations adopted under it are unavailable to a defendant in a criminal case, goes far toward undermining the purpose of Congress in enacting it.

To review that holding, and a conclusion of criminal intent inconsistent with the facts as found, the writ of certiorari sought by petitioner should be granted.

Respectfully submitted,

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May 19, 1972

Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 326—September Term, 1971

UNITED STATES OF AMERICA,

Appellee,

—v.—

SOL BERGER,

Appellant.

Before:

SMITH, KAUFMAN and MULLIGAN,

Circuit Judges.

SMITH, *Circuit Judge*:

Sol Berger appeals from a judgment of conviction on each of three counts of an indictment for the willful evasion of income tax due from the Colonial Corporation of America ("Colonial"), of which he was president and chief executive officer, by causing to be prepared and filed false corporate tax returns in each of the calendar years 1962, 1963 and 1964 (26 U.S.C. §7201 and 18 U.S.C. §2). After trial without a jury in the United States District Court for the Southern District of New York, 325 F. Supp. 1297 (1971), the Honorable Edward Weinfeld found appellant guilty and sentenced him to serve concurrent eighteen month prison terms on each count, fifteen months of which were suspended, to one year probation upon re-

lease from jail, and to pay a total of $30,000 in fines. Appellant insists that no substantial unreported tax was due from Colonial in the relevant years, and that, in any event, there was an insufficient showing he had acted with criminal intent. We disagree with both contentions and affirm the conviction.

Colonial, once wholly owned by appellant and his wife, became a large and successful manufacturer and wholesaler of low priced wearing apparel, making its first public offering of shares in 1959. Appellant, however, retained control of the firm and remained chief executive officer during the relevant period, his ownership never falling below 38% of the outstanding stock. Appellant sold his entire interest in 1966 when Colonial was merged into Kayser-Roth Corporation.

In 1959, already parent to several wholly-owned subsidiaries whose output it largely consumed, Colonial conceived yet another, Colonial Shirts of Jamaica, Ltd. ("Jamaica"), a foreign corporation benefiting from its permanent exemption from United States taxes and seven year exemption from Jamaican taxes, as well as from access to cheap labor. Jamaica procured piece goods (fabric) and trim (threads, buttons, labels) from vendors in Japan and elsewhere, who invoiced their sales to Jamaica, which then sold its entire production of finished shirts to Colonial. Appellant maintains that the price paid Jamaica for its output was unrealistically low in order to lessen custom duties on import, albeit customs officials necessarily approved the constructed price (19 U.S.C. §1401(a)) for the shirts in this non-arms length transaction. Purportedly to allow its subsidiary a fair profit, Colonial adopted the practice of supplementing the invoice price by making payments directly to the vendors supplying

Jamaica with piece goods and trim. The payments were made not at a fixed amount for each shirt purchased, but by randomly selecting Jamaica invoices for payment to total an arbitrary sum of $50,000 to $75,000 each quarter. Colonial then entered these payments to Jamaica's creditors on Colonial's own purchase journal, resulting in their deduction from its gross income, and a corresponding reduction in taxes paid. Colonial was thereby able to create for Jamaica "fair" profit margins of 28%, 28% and 29% in the relevant years, rather than the profit margins of 6%, 13% and 9% which Jamaica would have enjoyed at the constructed price had it paid all its own bills; on these profits, no taxes at all were paid.

Appellant contends that the supplemental payments were fairly an indirect cost to Colonial for its goods sold, which, when added to the prices invoiced by Jamaica, resulted in a fair arms length price for the garments purchased.[1] Since the alternative, the argument concludes, would simply be to add the cost of the supplemental payments to Jamaica's invoiced prices, the same income tax would be paid by Colonial either way. Assuming, *arguendo,* that such a conclusion is logically correct,[2] appellant's hypothetical restructuring of the taxable transaction is irrelevant to our examination of his actual conduct. *United States* v. *Campbell,* 351 F.2d 336, 340 (2d Cir. 1965),

[1] Appellant does not dispute that if his theory was incorrect, the amount of tax due and owing from Colonial was substantial.

[2] The established constructed price was, after all, carefully substantiated by Colonial, approved by a United States Customs examiner, and based on the premise that Jamaica would pay its own costs for piece goods and trim; it allowed Jamaica an average profit margin of roughly 8%. Although naturally kept as low as possible to minimize import duties, the constructed price does not appear to have been unrealistic.

cert. denied, 383 U.S. 907 (1966); *United States* v. *Vardine,* 305 F.2d 60, 64 (2d Cir. 1962). We are concerned not with whether appellant might have sought a higher constructed price for Jamaica's apparel, thereby achieving similar deductions for Colonial while simultaneously paying higher customs duties and reducing the untaxed profit to Jamaica, but with the propriety of the procedure in fact used: the clandestine payment of Jamaica's bills in order to manipulate Colonial's profits while paying lower customs duties and maintaining Jamaica's untaxed profits at levels approaching 30%.

In maintaining that Colonial was indeed entitled to take the disputed deductions, appellant concedes the fundamental principles that a parent corporation and its subsidiary are separate taxable entities, however close their relationship, *National Carbide Corp.* v. *Commissioner,* 336 U.S. 422 (1949), and that, ordinarily, a parent cannot deduct expenses incurred by its subsidiary. *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590 (1943). *See* 26 U.S.C. §162(a). Rather appellant seeks to place himself within the ambit of those exceptional cases such as *Fishing Tackle Products Co.,* 27 T.C. 638 (1957) and *Texas and Pacific Ry.,* 1 C.C.H. Tax Ct. Mem. 863 (1943), which under unusual circumstances allow a parent corporation to deduct as ordinary and necessary expenses items expended for a subsidiary. In *Fishing Tackle* the deducted payment, appearing openly on the parent's books, was a temporary measure to compensate its subsidiary for an actual loss in its operations. Moreover, the subsidiary in that case was the sole source of supply of a product for which the original, arbitrarily established, price had proved inadequate, and was therefore indispensable to the parent's continued operation.

Similarly in *Texas and Pacific Ry.*, the deducted payment exactly equalled the operational loss of a subsidiary which had been organized solely to provide a service to the parent, and not to make a profit. Far different is the instant case involving an ongoing and hidden system by a parent corporation to make payments to the creditors of its subsidiary, one not necessary to the continued existence of its parent, in order to increase the already significant tax free profits which that subsidiary could have expected on the basis of the carefully documented constructed price for its output. The piece goods and trim billed to Jamaica, but paid for and deducted by Colonial, were no more than the routine manufacturing expenses of Jamaica.[3] As the district court observed: "[s]uch payments would not be deductible as an expense to Colonial, but would be considered a contribution or a loan to capital of Jamaica." 325 F. Supp. at 1302.

Addressing itself to the issue of criminal intent, the district court stated that:

> [b]ased upon the Court's trial notes, which include its contemporaneous appraisal of each witness, a word by word study and reading of the stenographic transcript of the trial, the demeanor of the witnesses, an evaluation of their credibility and the reasonable inferences to be drawn from established facts and surrounding circumstances, the Court accepts the substance of the testimony of the government witnesses as credible,

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[3] Having found the fraudulent deduction by Colonial of expenses properly attributable to Jamaica, we are, as we have said, not concerned with alternate procedures appellant might legitimately have employed to reach the tax result he sought. We agree with the district court that 26 U.S.C. §482 does not pertain to the case at bar. *See* 26 C.F.R. §1.482-1(b).

and their version of the matters referred to as substantially true.
[325 F. Supp. at 1305]

The government's independent evidence of willful affirmative acts beyond its proof of understated taxes, *Spies* v. *United States,* 317 U.S. 492, 499 (1943) included the following: (1) appellant directed Colonial's bookkeeper to remove Jamaica invoices in the amount of $50,000 to $75,000 each quarter for treatment as expenses on the books of Colonial; (2) he and only he received from the bookkeeper separate records which were kept of each false entry; (3) he concealed this procedure from all other top officers of Colonial, from Colonial's accountants and from its outside auditors. Appellant's denials not having been credited by the trial court, its finding of criminal intent beyond a reasonable doubt is amply supported by the evidence.

Affirmed.

Judgment of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the twentieth day of March one thousand nine hundred and seventy-two.

Present:

HON. J. JOSEPH SMITH,
HON. IRVING R. KAUFMAN,
HON. WILLIAM H. MULLIGAN,
Circuit Judges.

UNITED STATES OF AMERICA,

Plaintiff-Appellee,

—v.—

SOL BERGER,

Defendant-Appellant.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed with costs to be taxed against the appellant.

A. DANIEL FUSARO
Clerk

Order Denying Petition for Rehearing

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

71-1856

UNITED STATES OF AMERICA,

Plaintiff-Appellee,

—v.—

SOL BERGER,

Defendant-Appellant.

A petition for a rehearing having been filed herein by counsel for the appellant,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is DENIED.

April 20, 1972

J. JOSEPH SMITH
IRVING R. KAUFMAN
WILLIAM H. MULLIGAN
Circuit Judges

Opinion of the District Court

UNITED STATES OF AMERICA

vs.

SOL BERGER

EDWARD WEINFELD, *District Judge*:

While many witnesses have testified and many exhibits have been received in evidence, with a tendency at times on the part of counsel to proliferate matters by the introduction of doubtful relevant testimony and exhibits, the issues presented are comparatively simple.

Thus, it is desirable to start with the indictment, to consider the essential elements of the crime charged, and to determine whether the government has sustained its burden of establishing these essential elements beyond a reasonable doubt.

Count 1 of the indictment charges:

> "The Grand Jury charges:
>
> "On or about the 17th day of June, 1963, in the Southern District of New York, Sol Berger, the defendant who was then and there the president and chief executive officer of Colonial Corporation of America, a cor-

poration, unlawfully, wilfully and knowingly did attempt to evade and defeat a large part of the income tax due and owing by the said corporation to the United States of America for the calendar year of 1962, by preparing and causing to be prepared and filing and causing to be filed with the District Director of Internal Revenue for the Manhattan District, New York, New York, a false and fraudulent income tax return, wherein it was stated that the taxable income of the said corporation for the said calendar year was the sum of $1,360,287.06 and that the amount of income tax due and owing thereon was the sum of $690,024.48, whereas, as the defendant then and there well knew, the taxable income of the said corporation for the said calendar year was the sum of approximately $1,654,-430.72, upon which said taxable income there was due and owing to the United States of America an income tax of approximately $842,979.19. (Title 26, United States Code, Section 7201; Title 18, United States Code, Section 2.)"

A similar charge is made for the years 1963 and 1964, but the amounts of alleged evasion of tax are different in each year.

With respect to each count, the burden of proof is upon the government to establish beyond a reasonable doubt:

(1) that a substantial tax was due and owing from Colonial Corporation of America in addition to that reported in its return;

(2) that Sol Berger, the defendant, made an attempt to evade or defeat the additional tax due; and

(3) that he did so wilfully.

At the outset, issue is joined on the first element, that additional taxes were due—a matter of sharp dispute. The defendant, in the years in question, and in preceding years, was the chief executive officer of Colonial Corporation of America (hereafter Colonial, or the parent corporation). Originally, he and his wife owned 100 per cent of its capital stock. The corporation achieved a substantial success and growth in the manufacture, sale and distribution of low-priced shirts, blouses and related items. Subsequently, in the latter part of 1959, the stock was sold publicly, and in the period in question the defendant and his wife owned at least 38 per cent of Colonial's outstanding stock. The corporation had various wholly-owned subsidiaries which manufactured products and sold most of their output to the parent corporation.

In 1959, the defendant caused the organization of another wholly-owned subsidiary, Colonial Shirts of Jamaica, Ltd. (hereafter Jamaica, or the subsidiary), under the laws of Jamaica, British West Indies, a so-called offshore corporation, which had the benefit of tax exemption for a period of seven years. In addition, another advantage was an available labor supply at lower wages than that obtainable in the domestic market, where other subsidiaries of Colonial also manufactured shirts, as well as other products.

Colonial bought for resale to its retailers the entire production of the finished products manufactured by Jamaica. The price at which the manufactured product was shipped

to and exported from Jamaica, British West Indies, to Colonial in the United States was the constructed value, referred to hereafter. In the manufacture of the shirts so acquired by the parent corporation the subsidiary used piece goods, which had been imported from Japan, which the vendors there invoiced to Jamaica, the subsidiary. A portion of the cost of these piece goods, as well as trim and supplies—$294,251 in 1962, $237,023 in 1963, and $383,-412 in 1964—although invoiced by the vendors to Jamaica and used by it in the manufacture of the finished product, was entered on the books of Colonial as its purchases. The net effect, no matter how stated, is that the entries in Colonial's purchase journal—treating the cost of piece goods and the other items as Colonial's cost, and deductible as such—reduced the gross income of Colonial of America as shown on its tax returns, and correspondingly reduced its tax in each year. Stating it somewhat differently, had Jamaica, the subsidiary, been debited with the entire cost of the piece goods, as well as items of supply and trim, used by it to manufacture the finished product which it exported to its parent, the taxable income of the parent would have been increased, as shown by the exhibits submitted by the government in the amounts stated in the indictment.

Whether or not those amounts of additional taxable income are precise, they are substantial and the tax due and owing substantially more than that reported. And this is so, even eliminating the trim and supplies, since the piece goods formed the greatest part of the items so entered. The piece goods debits alone amount to $261,370 for the year 1962; $192,121 for the year 1963; and $307,668 for the year 1964.

The government's position is that entering these items on the purchase journals of Colonial and treating them as a part of its cost of goods sold was fraudulent in that the cost was a part of Jamaica's cost of manufacture, and that the defendant caused such items to be debited to Colonial's purchase journals in an attempt to evade or defeat a portion of Colonial's taxes.

The defendant's position is that Colonial was entitled to offset from its gross receipts the cost of raw materials, including the piece goods, trim and supplies, which it paid for; that "expensing," as the term has been used, of the piece goods by Colonial was an indirect cost to it of goods sold. The defendant's further claim is that the entries reflected, in accordance with Colonial's policy, an adjustment to allocate a fair portion of the profits to Jamaica and, to use the language of his counsel, "(h)ad the allocation not been made, the subsidiary would have had to operate at a loss or at a relatively trifling profit well below the profits" of the parent corporation. However, the record does not bear out the contention that the subsidiary was operating at a trifling profit or a loss.

The finished shirts and blouses exported by Jamaica to its parent were subject to an import duty. Since the transactions were not at arm's length, a constructed value was determined under 19 U. S. C., Section 1401a. In substance, "constructed value" is the sum of the cost of materials, fabrication, processing, overhead, general expenses and profit equal to that usually reflected in sales of merchandise of the same kind by producers in the country of exportation. The "constructed price" was arrived at as a result of conferences between Leonard Friedman, in charge

of production of all the companies owned by the parent and customs officials. The imported goods were invoiced, as they had to be under the statute, at the constructed price, on which a duty of 20 or 25 per cent, according to the item of merchandise, was payable.

There appears to be no dispute that the constructed value, the invoice price to Colonial, was at a low price, which some witnesses described as not reflecting a realistic price, or a fair price for the exported product.

And the defense position that no tax is due derives in large measure from this situation. The claim is that since the price at which Jamaica billed the goods to Colonial was too low, in order to yield a fair profit to Jamaica or one proportionate to the profit realized by Colonial in the resale of the product, Colonial absorbed part of the expense for the piece goods and other items used in the manufacture of the finished product, and that the adjustments were made for this purpose and consistent with Colonial's alleged basic policy to allow a fair profit to its subsidiaries. But this does not resolve the question as to whether or not the so-called adjustments or entries in the purchase journals of Colonial, under the circumstances here presented, reflected items of necessary expense of Colonial's business or its cost of goods sold.

The defendant's position also is that had all piece goods and other raw materials been charged to Jamaica as part of its cost of production, the same gross profit would have been divided between Colonial and Jamaica, but on a different profit ratio.

The various conceptual and alternative theories of what might have been done must yield to the facts. The Court

must take the transactions as they occurred and in the manner they were treated at the time of the occurrence. It is the fact situation at the time of the alleged offense that controls.

> United States v. Vardine, 305 F. 2d 60, 64 (2d Cir. 1962);
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> Scanlon v. United States, 223 F. 2d 382, 389 (1st Cir. 1955);
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> Clark v. United States, 211 F. 2d 100, 105 (8th Cir. 1954), *cert. denied,* 348 U.S. 911 (1955); *cf.* National Carbide Corp. v. Commissioner, 336 U. S. 422, 435 (1949).

The simple fact is that had all the piece goods and raw materials invoiced to Jamaica by foreign vendors and others, and used in the manufacture of the finished shirts and blouses, been entered on the books of Jamaica as its cost of production, an increase in the constructed price charged to Colonial would have been required, with the income picture of both corporations affected accordingly; or as defense counsel put it:

> "(t)he only alternative to the adjustments would have been to charge the Jamaican subsidiaries for the full amount of purchases and supplies and in turn to have increased the amount of the billings to the parent from the Jamaican subsidiaries by an equivalent amount."

The policy of Colonial was to keep the constructed price down, since the higher the price the higher the duty that

Colonial had to pay. In end result, this reduced customs duties on the merchandise and the adjustments also reduced Colonial's taxable income.

The corporations were separate entities; however, this did not give Colonial the right to make intercompany adjustments as it willed—but only within the law. *Cf.* National Carbide Corp. v. Commissioner, 336 U.S. 422, 434-36 (1949). The basic rule is that for tax purposes, parent and wholly-owned subsidiaries are treated as separate entities no matter how closely affiliated. Ordinarily, the separate corporate entities of parent and subsidiary preclude the parent from deducting expenses incurred by its subsidiary. The concept is that the payment by the parent to cover such expenses is related to the business of the subsidiary and not its own business, and as such is not deductible.

Fall River Gas Appliance Co. v. Commissioner, 42 T.C. 850, 858 (1964), *aff'd* 349 F. 2d 515 (1st Cir. 1965);

see also National Carbide Corp. v. Commissioner, 336 U. S. 422 (1949);

Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943);

Young & Rubicam, Inc. v. United States, 410 F. 2d 1233 (Ct. Cl. 1969);

Columbian Rope Co., 42 T. C. 800 (1964).

It is true that items expended for a subsidiary *may* be deductible by a parent corporation as an ordinary or necessary expense of the parent, such as was allowed in Fishing Tackle Prods. Co., 27 T. C. 638 (1957), and Fall River

Gas Appliance Co. v. Commissioner, 42 T. C. 850 (1964), but only under unique and compelling circumstances. It is significant that in the *Fishing Tackle* case the parent needed the product of the subsidiary, which was its sole source of supply and without which the parent would have been unable to meet the demands of its customers and its position in the industry threatened. The payments made by the parent covered operating losses of the subsidiary and were held deductible as a necessary business expense made to maintain and preserve its source of supply. The threatened elimination of the parent's sole source of supply, without which it would have ceased operation, was the compelling circumstance underlying the court's holding.

However, the facts of this case do not parallel those of *Fishing Tackle*. The cost of the piece goods and other items used by Jamaica was part of its day to day manufacturing activity in furtherance of its business. Without the raw materials there could be no finished product. The piece goods used by Jamaica in the manufacture of the shirts were, to use the words of Colonial's production chief, "a vital component of our cost."

That Colonial supplied the funds for the purchase of the goods is not material, especially when Colonial had numerous other sources of supply. Such payments would not be deductible as an expense to Colonial, but would be considered a contribution or a loan to capital of Jamaica. *Cf.* Interstate Transit Lines v. Commissioner, 319 U. S. 590, 594 (1943). The cost of piece goods, as accurately as could be determined, was used in determining constructed value. That cost was Jamaica's ordinary and necessary expense

required in order to manufacture the finished product, and no amount of dialectical discussion of what might have occurred if the transaction had been treated differently can down that fact. That the payments by Colonial are now referred to as both a direct and indirect payment for the cost of goods acquired does not alter the fact.

Moreover, despite the reference to what might have been the end result of a "C, M, T," a cut, make and trim operation, this was not the situation that existed. The defendant participated in the decision that Jamaica was to function otherwise and was to manufacture the completed garment and that piece goods from the Far East were to be purchased by and billed directly to Jamaica.

The fact that the quarterly adjustments of piece goods invoices were taken at random and reflected only a portion of the invoices to Jamaica militates against the contention that the adjustments were made as a cost of goods sold to Colonial. The alternative argument that the items were absorbed by Colonial to "assure a fair profit" to Jamaica is faced with the fact that had the piece goods and other materials been expensed to Jamaica, Jamaica still would have reflected a profit, unlike the subsidiary in the *Fishing Tackle* case.

The defendant's contention that the piece goods and other items were properly charged to Colonial and deducted under section 482 of Title 26 is without substance. This is a section to be invoked by the Commissioner of Internal Revenue to allocate gross income or deductions between or among related businesses when the Commissioner deems it necessary to prevent the evasion of taxes or clearly to reflect the income of such businesses. Its purpose is to prevent

the arbitrary shifting of income and deductions among controlled and controlling corporations. 26 C. F. R. § 1.482-1 (b). It is not a delegation of authority to a parent to treat at will the necessary expenses of its subsidiary as its own, for the parent's benefit and to the detriment of government in its right to taxes justly due.

The Court finds with respect to the first essential element that the debit entries on the purchase journals of Colonial for the piece goods and other raw materials purchased by and invoiced to Jamaica, delivered by the vendors to Jamaica, which raw materials were used by Jamaica in the manufacture of the finished product, were improperly deducted by Colonial as its expense or its cost of goods sold; that the government has sustained its burden of proving that Colonial overstated its cost of goods sold in its tax returns for the years 1962, 1963 and 1964 by deducting expenses for goods acquired by Jamaica, which should not have been charged on the purchase journals of Colonial.

The Court further finds the government has established that a substantial amount of income tax was due and owing from Colonial for each tax year in question in addition to that set forth in the return for each year. A substantial additional tax was due even if only the piece goods items are taken into account, and trim and supplies excluded.

It necessarily follows, upon the entire evidence, that the returns in question were false in the material respect of the improper deductions by Colonial, and also that the defendant knew this. While the defendant urges he personally did not sign the Colonial returns, that they were prepared and executed by Epstein, the vice president in charge of financial matters for Colonial, the evidence is abundant

that the entries on Colonial's books of the cost of the invoiced items to Jamaica for the piece goods and other items were made at his direction and at all times with his knowledge—that they were made with his knowledge and consent is not in dispute. And he also knew the entries on Colonial's books would be reflected in Colonial's tax returns with consequent reduction of taxable income and taxes due. The fact that he himself did not sign the return is of no consequence. The government has sustained its burden as to the second element.

Thus, there remains for consideration the final element —did the defendant wilfully attempt to evade or defeat the additional tax due and owing. The presumption of innocence with which the law endows the defendant extends to every element of the crime charged, and here the question is whether the government has carried its burden of establishing that the defendant acted wilfully and with a specific intent to defraud the government of the taxes due.

The term "wilful" connotes deliberate, voluntary and purposeful action, with a specific wrongful intent to violate the law, as distinguished from inadvertent or accidental, or an honest misunderstanding of what the law requires or permits. Various terms have been used to define wilfulness or guilty knowledge, such as fraudulent intent, and evil motive, a bad motive, or a vicious will.

Cf. Morissette v. United States, 342 U. S. 246, 252 (1952);

see also United States v. Freed, —— U.S. —— (Apr. 5, 1971);

United States v. Platt, 435 F. 2d 789, 794 (2d Cir. 1970).

It has also been defined as a state of mind of a person wherein he is fully aware of the existence of a tax obligation which he seeks to conceal or evade.

> United States v. Martell, 199 F. 2d 670, 672 (3rd Cir. 1952), *cert. denied*, 345 U. S. 917 (1953); *see also* United States v. Vitiello, 363 F. 2d 240, 242 (3rd Cir. 1966).

However, wilfulness may not be inferred solely from proof of understated taxes. A specific intent to evade or defeat the tax must be proved by independent evidence of wilful affirmative acts. Spies v. United States, 317 U. S. 492, 499 (1942), the leading case on the element of wilfulness, points out some such acts which may be considered. These include making false entries and any conduct the likely effect of which would be to mislead or to conceal, and if the tax evasion motive plays any part in such conduct, the offense may be made out, even though the conduct may also serve other purposes.

To the extent that the entries of the invoices on Colonial's books were improper deductions, as the Court has already found, they may be said to be false; but this does not, in and of itself, necessarily establish that they were made or conceived of with a fraudulent and criminal intent to evade taxes. More must be shown by affirmative conduct to effect that purpose.

The government contends that the defendant's acts and conduct establish that the entries on Colonial's books which purported to be its expenses when in fact they were Jamaica's were not only false entries, but were made at the defendant's specific direction with the fraudulent in-

tent to defeat a portion of Colonial's taxes, and that his clandestine acts and conduct with respect to the transactions evidence a purpose to conceal and mislead, which the government contends in fact they did.

The determination of the issue of wilfulness turns in large measure upon the evaluation of the credibility of government witnesses and the defendant. Their respective versions of the original of the entries, knowledge of records with respect thereto, and other significant factors relating thereto are in sharp conflict.

Mrs. Milligan, the principal bookkeeper of the Colonial corporation, under whose immediate direction all entries were made in the books of original entry, testified that late in 1959 or early 1960, the defendant directed her to enter on Colonial's books a portion of the invoices for piece goods shipped and invoiced to the Jamaica corporation, in the approximate amounts of $50,000 to $75,000 in each quarter; such entries were made in Colonial's purchase journals; that the defendant asked her to keep a separate record of such transactions, which she did; that he was the sole person to whom she delivered, either in person or by mail, the reports of the quarter-annual entries.

Friedman, the production chief of all the companies, and Epstein, originally the certified public accountant for Colonial, and at the period here in question its chief financial officer, who, together with the defendant, constituted the top management team of Colonial, each categorically denied he ever knew of the entries, or that piece goods invoiced to Jamaica were treated on Colonial's books as its expense or purchase until early 1965, when they first learned of the practice, although each was aware of a general practice with

respect to trim and supplies delivered to Colonial's subsidiaries or contractors. Epstein and Friedman each denied they ever saw or received records or reports of the entries which Mrs. Milligan testified she submitted regularly to the defendant at the end of each quarter.

The government also points to the testimony that the regular accountants of Colonial and those working under them were unaware that piece goods, trim and supplies invoiced to Jamaica were not entered on its books, but instead on the purchase journal of Colonial as its own purchases, and this was also true of the company's outside auditors.

Finally, while the bookkeeper knew the entries were made, she was not told the purpose thereof; she just did what she was told to do.

This and other evidence, the government contends, demonstrates that the defendant's acts were intentional and fraudulent; also that he concealed from the top executives and accountants the false nature of the entries. In sum—it contends it has established that what the defendant did amounted to padding the books of Colonial with expenses not its own—expenses that he knew were those of Jamaica.

The defendant, as already noted, contends that the entries were made as an adjustment to reflect a fair price and fair profit to Jamaica, consistent with Colonial's policy as to all its subsidiaries—in sum, that they were made in good faith without fraudulent purpose and that the transactions were open and known to others. He denied, or did not recall, that in 1959 or thereabouts he instructed Mrs. Milligan to make deductions, as she testified;

he denied he directed her to keep a record thereof or to report to him; he had no recollection of seeing specific reports of piece goods invoice adjustments, although he said such reports were submitted at the quarterly meetings when Friedman and Epstein were present. He testified, contrary to Epstein and Friedman, that usually at the quarter-annual meetings allocations between parent and subsidiaries, including Jamaica, were discussed and adjustments determined.

In sum, he testified that both Friedman and Epstein discussed and participated in the quarterly adjustments of the piece goods invoices, but was not sure how the information was transmitted to Mrs. Milligan to make the appropriate entries. On a number of matters of substance, defendant's testimony was vague and at times irresponsive.

The spiral notebooks in which Mrs. Milligan and others under her direction recorded the Jamaica piece goods invoices and other items, reports of which were either delivered or mailed to the defendant, are in evidence. These reports speak for themselves. Thus, one dated 12/31/62 reads:

"Mr. Berger

"Below are entries made on Colonial's books, which purchases and expense actually belong to Jamaica.

For—4th quarter"

Another, dated 3/31/63, reads:

"Mr. Berger,

"below are entries made on Colonial's books which actually belong to Jamaica."

Other reports use substantially the same language.

Also in evidence is an exhibit bearing defendant's typed name and the initials SB:HF, Exhibit 72B, dated May 22, 1961, addressed to Mrs. Milligan, which reads in part:

> "At the end of each month please send to me a list of transactions paid by Colonial which should have applied to Colonial Shirts of Jamaica."

An issue was raised as to whether or not it was the defendant himself who dictated and caused this letter to be sent. His testimony was that he had no recollection as to whether he dictated it. However, upon all the evidence, I am satisfied that the letter was dictated by the defendant and was mailed to Mrs. Milligan pursuant to his directions.

Based upon the Court's trial notes, which include its contemporaneous appraisal of each witness, a word-by-word reading and study of the stenographic transcript of the trial, the demeanor of the witnesses, an evaluation of their credibility and the reasonable inferences to be drawn from established facts and surrounding circumstances, the Court accepts the substance of the testimony of the government witnesses as credible, and their version of the matters referred to as substantially true.

Upon the entire record the Court finds that the government has also established beyond a reasonable doubt the requisite element of wilfulness.

Accordingly, the Court finds that the government has established beyond a reasonable doubt all the essential elements of the crime charged and finds the defendant guilty under each count.

The foregoing shall constitute the Court's Findings under Rule 23 of the Federal Rules of Criminal Procedure.

Judgment of the District Court

UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

No. 69 Cr. 496

UNITED STATES OF AMERICA

v.

SOL BERGER

On this 4th day of June, 1971, came the attorney for the government and the defendant appeared in person and by Boris Kostelanetz and Jules Ritholz, Esqs., counsel.

IT IS ADJUDGED that the defendant upon his plea of not guilty and a verdict of guilty by a jury has been convicted of the offense of unlawfully, wilfully and knowingly attempting to evade and defeat a large part of corporate income tax due and owing to the United States by filing false and fraudulent income tax returns. (Title 26, Section 7201 U.S. Code; Title 18, Section 2 U.S. Code.) as charged in counts 1, 2 and 3 and the court having asked the defendant whether he has anything to say why judgment should not be pronounced, and no sufficient cause to the contrary being shown or appearing to the Court,

IT IS ADJUDGED that the defendant is guilty as charged and convicted.

IT IS ADJUDGED that the defendant is hereby committed to the custody of the Attorney General or his authorized representative for imprisonment for a period of EIGHTEEN (18) MONTHS on each of counts 1, 2 and 3 to run concur-

rently with each other and pursuant to Section 3651 of Title 18, U.S. Code, as amended with provision that defendant be confined in a JAIL TYPE institution for a period of THREE (3) MONTHS.

IT IS ADJUDGED that the execution of prison sentence remaining be suspended and defendant placed on probation for a period of ONE (1) YEAR, to commence upon expiration of confinement, subject to the standing probation order of this Court.

—AND—

IT IS ADJUDGED that the defendant FINED $10,000 on each of counts 1, 2 and 3 plus cost of prosecution. Total fines of $30,000.00 plus cost of prosecution are to be paid or defendant to stand committed until the fines plus costs of prosecution are paid or he is otherwise discharged according to law.

Defendant continued on present bail until 4 P.M. today at which time he is to post Bail Pending Appeal in the amount of $10,000.00. Bail pending appeal conditioned upon the appeal being prosecuted expeditiously and in strict compliance with the rules of this Court and the Court of Appeals.

IT IS ORDERED that the Clerk deliver a certified copy of this judgment and commitment to the United States Marshal or other qualified officer and that the copy serve as the commitment of the defendant.

EDWARD WEINFELD
United States District Judge

JOHN LIVINGSTON
Clerk

Section 482 and Regulations

Sec. 482 [1954 Code]. In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

REGULATIONS

§ 1.482-1. Allocation of income and deductions among taxpayers.—(a) *Definitions.* When used in this section and in § 1.482-2—

(1) The term "organization" includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations thereunder), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The term "trade" or "business" includes any trade or business activity of any kind, regardless of whether or

where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term "controlled taxpayer" means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms "group" and "group of controlled taxpayers" mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.* (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an

uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(2) Section 482 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate taxable income. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

(3) Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions. It is not intended (except in the case of the computation of

consolidated taxable income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated taxable income under subchapter A, chapter 6 of the Code.

(c) *Application.* Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(d) *Method of allocation.* (1) The method of allocating, apportioning, or distributing income, deductions, credits, and allowances to be used by the district director in any case, including the form of the adjustments and the character and source of amounts allocated, shall be determined with reference to the substance of the particular transactions or arrangements which result in the avoidance of taxes or the failure to clearly reflect income. The appropriate adjustments may take the form of an increase or

decrease in gross income, increase or decrease in deductions (including depreciation), increase or decrease in basis of assets (including inventory), or any other adjustment which may be appropriate under the circumstances. See § 1.482-2 for specific rules relating to methods of allocation in the case of several types of business transactions.

(2) Whenever the district director makes adjustments to the income of one member of a group of controlled taxpayers (such adjustments being referred to in this paragraph as "primary" adjustments) he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation. The correlative adjustment shall actually be made if the U. S. income tax liability of the other member would be affected for any pending taxable year. Thus, if the district director makes an allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the U. S. income tax liability of the other member for any pending taxable year. For the purposes of this subparagraph, a "pending taxable year" is any taxable year with respect to which the U. S. income tax return of the other member has been filed by the time the allocation is made, and with respect to which a credit or refund is not barred by the operation of any law or rule of law. If a correlative adjustment is not actually made because it would have no effect on the U. S. income tax liability of the other member involved in the allocation for any pending taxable year, such adjustment shall nevertheless be deemed to have been made for the purpose of determining the U. S. income tax liability of such member for a later taxable year, or for the

purposes of determining the U. S. income tax liability of any person for any taxable year. The district director shall furnish to the taxpayer with respect to which the primary adjustment is made a written statement of the amount and nature of the correlative adjustment which is deemed to have been made. For purposes of this subparagraph, a primary adjustment shall not be considered to have been made (and therefore a correlative adjustment is not required to be made) until the first occurring of the following events with respect to the primary adjustment:

(i) The date of assessment of the tax following execution by the taxpayer of a Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) with respect to such adjustment,

(ii) Acceptance of a Form 870-AD (Offer of Waiver of Restriction on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment),

(iii) Payment of the deficiency,

(iv) Stipulation in the Tax Court of the United States, or

(v) Final determination of tax liability by offer-in-compromise, closing agreement, or court action.

The principles of this subparagraph may be illustrated by the following examples in each of which it is assumed that X and Y are members of the same group of controlled entities and that they regularly compute their incomes on the basis of a calendar year:

Example (1). Assume that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length rental charge for Y's use of X's tangible property

in 1966; that X consents to an assessment reflecting such adjustment by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. The primary adjustment is therefore considered to have been made in 1968. Assume further that both X and Y are United States corporations and that Y had net operating losses in 1963, 1964, 1965, 1966, and 1967. Although a correlative adjustment would not have an effect on Y's U. S. income tax liability for any pending taxable year, an adjustment increasing Y's net operating loss for 1966 shall be deemed to have been made for the purposes of determining Y's U. S. income tax liability for 1968 or a later taxable year to which the increased operating loss may be carried. The district director shall notify X in writing of the amount and nature of the adjustment which is deemed to have been made to Y.

Example (2). Assume that X and Y are United States corporations; that X is in the business of rendering engineering services; that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length fee for the rendition of engineering services by X in 1966 relating to the construction of Y's factory; that X consents to an assessment reflecting such adjustment by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. Assume further that fees for such services would properly constitute a capital expenditure by Y, and that Y does not place the factory in service until 1969. Although a correlative adjustment (increase in basis) would not have an effect on Y's U. S. income tax liability for a pending taxable year, an adjustment increasing the basis of Y's assets for 1966 shall be deemed to have been made in 1968 for

the purpose of computing allowable depreciation or gain or loss on disposition for 1969 and any future taxable year. The district director shall notify X in writing of the amount and nature of the adjustment which is deemed to have been made to Y.

Example (3). Assume that X is a U. S. taxpayer and Y is a foreign taxpayer not engaged in a trade or business in the United States; that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length interest charge on a loan made to Y; that X consents to an assessment reflecting such allocation by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. Although a correlative adjustment would not have an effect on Y's U. S. income tax liability, an adjustment in Y's income for 1966 shall be deemed to have been made in 1968 for the purposes of determining the amount of Y's earnings and profits for 1966 and subsequent years, and of any other effect it may have on any person's U. S. income tax liability for any taxable year. The district director shall notify X in writing of the amount and nature of the allocation which is deemed to have been made to Y.

(3) In making distributions, apportionments, or allocations between two members of a group of controlled entities with respect to particular transactions, the district director shall consider the effect upon such members of an arrangement between them for reimbursement within a reasonable period before or after the taxable year if the taxpayer can establish that such an arrangement in fact existed during the taxable year under consideration. The district director shall also consider the effect of any other nonarm's length transaction between them in the taxable

year which, if taken into account, would result in a setoff against any allocation which would otherwise be made, provided the taxpayer is able to establish with reasonable specificity that the transaction was not at arm's length and the amount of the appropriate arm's length charge. For purposes of the preceding sentence, the term arm's length refers to the amount which was charged or would have been charged in independent transactions with unrelated parties under the same or similar circumstances considering all the relevant facts and without regard to the rules found in § 1.482-2 by which certain charges are deemed to be equal to arm's length. For example, assume that one member of a group performs services which benefit a second member, which would in itself require an allocation to reflect an arm's length charge for the performance of such services. Assume further that the first member can establish that during the same taxable year the second member engages in other nonarm's length transactions which benefit the first member, such as by selling products to the first member at a discount, or purchasing products from the first member at a premium, or paying royalties to the first member in an excessive amount. In such case, the value of the benefits received by the first member as a result of the other activities will be set off against the allocation which would otherwise be made. If the effect of the set-off is to change the characterization or source of the income or deductions, or otherwise distort taxable income, in such a manner as to affect the United States tax liability of any member, allocations will be made to reflect the correct amount of each category of income or deductions. In order to establish that a set-off to the adjustments proposed by the district director is appropriate, the taxpayer must notify the district director of the basis

of any claimed set-off at any time before the expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments or before July 16, 1968, whichever is later. The principles of this subparagraph may be illustrated by the following examples, in each of which it is assumed that P and S are calendar year corporations and are both members of the same group of controlled entities:

Example (1). P performs services in 1966 for the benefit of S in connection with S's manufacture and sale of a product. S does not pay P for such services in 1966, but in consideration for such services, agrees in 1966 to pay P a percentage of the amount of sales of the product in 1966 through 1970. In 1966 it appeared this agreement would provide adequate consideration for the services. No allocation will be made with respect to the services performed by P.

Example (2). P renders services to S in connection with the construction of S's factory. An arm's length charge for such services, determined under paragraph (b) of § 1.482-2, would be $100,000. During the same taxable year P makes available to S a machine to be used in such construction. P bills S $125,000 for the services, but does not bill for the use of the machine. No allocation will be made with respect to the excessive charge for services or the undercharge for the machine if P can establish that the excessive charge for services was equal to an arm's length charge for the use of the machine, and if the taxable income and income tax liabilities of P and S are not distorted.

Example (3). Assume the same facts as in example (2), except that, if P had reported $25,000 as rental income and

$25,000 less service income, it would have been subject to the tax on personal holding companies. Allocations will be made to reflect the correct amounts of rental income and service income.

(4) If the members of a group of controlled taxpayers engage in transactions with one another, the district director may distribute, apportion, or allocate income, deductions, credits, or allowances to reflect the true taxable income of the individual members under the standards set forth in this section and in § 1.482-2 notwithstanding the fact that the ultimate income anticipated from a series of transactions may not be realized or is realized during a later period. For example, if one member of a controlled group sells a product at less than an arm's length price to a second member of the group in one taxable year and the second member resells the product to an unrelated party in the next taxable year, the district director may make an appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, notwithstanding that the second member of the group had not realized any gross income from the resale of the product in the first year. Similarly, if one member of a group lends money to a second member of the group in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second member does not realize income during such year. The provisions of this subparagraph apply even if the gross income contemplated from a series of transactions is never, in fact, realized by the other members.

(5) Section 482 may, when necessary to prevent the avoidance of taxes or to clearly reflect income, be applied in circumstances described in sections of the Code (such

as section 351) providing for nonrecognition of gain or loss. See, for example, *National Securities Corporation* v. *Commissioner of Internal Revenue*, 137 F.2d 600 (3rd Cir. 1943), cert. denied 320 U. S. 794 (1943).

(6) If payment or reimbursement for the sale, exchange, or use of property, the rendition of services, or the advance of other consideration among members of a group of controlled entities was prevented, or would have been prevented, at the time of the transaction because of currency or other restrictions imposed under the laws of any foreign country, any distributions, apportionments, or allocations which may be made under section 482 with respect to such transactions may be treated as deferrable income or deductions, providing the taxpayer has, for the year to which the distributions, apportionments, or allocations relate, elected to use a method of accounting in which the reporting of deferrable income is deferred until the income ceases to be deferrable income. Under such method of accounting, referred to in this section as the deferred income method of accounting, any payments or reimbursements which were prevented or would have been prevented, and any deductions attributable directly or indirectly to such payments or reimbursements, shall be deferred until they cease to be deferrable under such method of accounting. If such method of accounting has not been elected with respect to the taxable year to which the allocations under section 482 relate, the taxpayer may elect such method with respect to such allocations (but not with respect to other deferrable income) at any time before the first occurring of the following events with respect to the allocations:

(i) Execution by the taxpayer of Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment);

(ii) Expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of the proposed adjustments reflecting such allocations or before July 16, 1968, whichever is later; or

(iii) Execution of a closing agreement or offer-in-compromise. The principles of this subparagraph may be illustrated by the following example in which it is assumed that X, a domestic corporation, and Y, a foreign corporation, are members of the same group of controlled entities:

Example. X, which is in the business of rendering a certain type of service to unrelated parties, renders such services for the benefit of Y in 1965. The direct and indirect costs allocable to such services are $60,000, and an arm's length charge for such services is $100,000. Assume that the district director proposes to increase X's income by $100,000, but that the country in which Y is located would have blocked payment in 1965 for such services. If, prior to the first occurring of the events described in subdivisions (i), (ii), or (iii) of this subparagraph, X elects to use the deferred income method of accounting with respect to such allocation, the $100,000 allocation and the $60,000 of costs are deferrable until such amounts cease to be deferrable under X's method of accounting. [Reg. § 1.482-1.]

§ 1.482-2. DETERMINATION OF TAXABLE INCOME IN SPECIFIC SITUATIONS.—(a) *Loans or advances*—(1) *In general.* Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest, or charges interest at a rate which is not equal to an arm's length rate as defined in subparagraph (2) of this paragraph, the district director may make

appropriate allocations to reflect an arm's length interest rate for the use of such loan or advance.

(2) *Arm's length interest rate.* For the purposes of this paragraph, the arm's length interest rate shall be the rate of interest which was charged, or would have been charged at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances.

• • •

(b) *Performance of services for another*—(1) *General rule.* Where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group without charge, or at a charge which is not equal to an arm's length charge as defined in subparagraph (3) of this paragraph, the district director may make appropriate allocations to reflect an arm's length charge for such services.

• • •

(3) *Arm's length charge.* For the purpose of this paragraph an arm's length charge for services rendered shall be the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts.

• • •

(c) *Use of tangible property*—(1) *General rule.* Where possession, use, or occupancy of tangible property owned or leased by one member of a group of controlled entities (referred to in this paragraph as the owner) is transferred by lease or other arrangement to another member of such

group (referred to in this paragraph as the user) without charge or at a charge which is not equal to an arm's length rental charge (as defined in subdivision (i) of subparagraph (2) of this paragraph), the district director may make appropriate allocations to properly reflect such arm's length charge. Where possession, use, or occupancy of only a portion of such property is transferred, the determination of the arm's length charge and the allocation shall be made with reference to the portion transferred.

(2) *Arm's length charge.* (i) For the purposes of this paragraph, an arm's length rental charge shall be the amount of rent which was charged, or would have been charged for the use of the same or similar property, during the time it was in use, in independent transactions with or between unrelated parties under similar circumstances considering the period and location of the use, the owner's investment in the property or rent paid for the property, expenses of maintaining the property, the type of property involved, its condition, and all other relevant facts.

• • •

(d) *Transfer or use of intangible property*—(1) *In general.* (i) Except as otherwise provided in subparagraph (4) of this paragraph, where intangible property or an interest therein is transferred, sold, assigned, loaned, or otherwise made available in any manner by one member of a group of controlled entities (referred to in this paragraph as the transferor) to another member of the group (referred to in this paragraph as the transferee) for other than an arm's length consideration, the district director may make appropriate allocations to reflect an arm's length consideration for such property or its use.

• • •

(2) *Arm's length consideration.* (i) An arm's length consideration shall be in a form which is consistent with the form which would be adopted in transactions between unrelated parties under the same circumstances.

• • •

(e) *Sales of tangible property*—(1) *In general.* (i) Where one member of a group of controlled entities (referred to in this paragraph as the "seller") sells or otherwise disposes of tangible property to another member of such group (referred to in this paragraph as the "buyer") at other than an arm's length price (such a sale being referred to in this paragraph as a "controlled sale"), the district director may make appropriate allocations between the seller and the buyer to reflect an arm's length price for such sale or disposition. An arm's length price is the price that an unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Since unrelated parties normally sell products at a profit, an arm's length price normally involves a profit to the seller.

(ii) Subparagraphs (2), (3), and (4) of this paragraph describe three methods of determining an arm's length price and the standards for applying each method. They are, respectively, the comparable uncontrolled price method, the resale price method, and the cost plus method. In addition, a special rule is provided in subdivision (v) of this subparagraph for use (notwithstanding any other provision of this subdivision) in determining an arm's length price for an ore or mineral. If there are comparable uncontrolled sales as defined in subparagraph (2) of this paragraph, the comparable uncontrolled price method must

be utilized because it is the method likely to result in the most accurate estimate of an arm's length price (for the reason that it is based upon the price actually paid by unrelated parties for the same or similar products). If there are no comparable uncontrolled sales, then the resale price method must be utilized if the standards for its application are met because it is the method likely to result in the next most accurate estimate in such instances (for the reason that, in such instances, the arm's length price determined under such method is based more directly upon actual arm's length transactions than is the cost plus method). A typical situation where the resale price method may be required is where a manufacturer sells products to a related distributor which, without further processing, resells the products in uncontrolled transactions. If all the standards for the mandatory application of the resale price method are not satisfied, then, as provided in subparagraph (3)(iii) of this paragraph, either that method or the cost plus method may be used, depending upon which method is more feasible and is likely to result in a more accurate estimate of an arm's length price. A typical situation where the cost plus method may be appropriate is where a manufacturer sells products to a related entity which performs substantial manufacturing, assembly, or other processing of the product or adds significant value by reason of its utilization of its intangible property prior to resale in uncontrolled transactions.

(iii) Where the standards for applying one of the three methods of pricing described in subdivision (ii) of this subparagraph are met, such method must, for the purposes of this paragraph, be utilized unless the taxpayer can establish that, considering all the facts and circumstances, some

method of pricing other than those described in subdivision (ii) of this subparagraph is clearly more appropriate. Where none of the three methods of pricing described in subdivision (ii) of this subparagraph can reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described in subdivision (ii) of this subparagraph, or variations on such methods, can be used.

(iv) The methods of determining arm's length prices described in this section are stated in terms of their application to individual sales of property. However, because of the possibility that a taxpayer may make controlled sales of many different products, or many separate sales of the same product, it may be impractical to analyze every sale for the purposes of determining the arm's length price. It is therefore permissible to determine or verify arm's length prices by applying the appropriate methods of pricing to product lines or other groupings where it is impractical to ascertain an arm's length price for each product or sale. In addition, the district director may determine or verify the arm's length price of all sales to a related entity by employing reasonable statistical sampling techniques.

(v) The price for a mineral product which is sold at the stage at which mining or extraction ends shall be determined under the provisions of §§ 1.613-3 and 1.613-4.

(2) *Comparable uncontrolled price method.* (i) Under the method of pricing described as the "comparable uncontrolled price method", the arm's length price of a controlled sale is equal to the price paid in comparable uncontrolled sales, adjusted as provided in subdivision (ii) of this subparagraph.

(ii) "Uncontrolled sales" are sales in which the seller and the buyers are not members of the same controlled group. These include (*a*) sales made by a member of the controlled group to an unrelated party, (*b*) sales made to a member of the controlled group by an unrelated party, and (*c*) sales made in which the parties are not members of the controlled group and are not related to each other. However, uncontrolled sales do not include sales at unrealistic prices, as for example where a member makes uncontrolled sales in small quantities at a price designed to justify a nonarm's length price on a large volume of controlled sales. Uncontrolled sales are considered comparable to controlled sales if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales, or if such properties and circumstances are so nearly identical that any differences either have no effect on price, or such differences can be reflected by a reasonable number of adjustments to the price of uncontrolled sales. For this purpose, differences can be reflected by adjusting prices only where such differences have a definite and reasonably ascertainable effect on price. If the differences can be reflected by such adjustment, then the price of the uncontrolled sale as adjusted constitutes the comparable uncontrolled sale price. Some of the differences which may affect the price of property are differences in the quality of the product, terms of sale, intangible property associated with the sale, time of sale, and the level of the market and the geographic market in which the sale takes place. Whether and to what extent differences in the various properties and circumstances affect price, and whether differences render sales noncomparable, depends upon the

particular circumstances and property involved. The principles of this subdivision may be illustrated by the following examples, in each of which it is assumed that X makes both controlled and uncontrolled sales of the identical property:

Example (1). Assume that the circumstances surrounding the controlled and the uncontrolled sales are identical, except for the fact that the controlled sales price is a delivered price and the uncontrolled sales are made f. o. b. X's factory. Since differences in terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, such differences do not normally render the uncontrolled sales noncomparable to the controlled sales.

Example (2). Assume that the circumstances surrounding the controlled and uncontrolled sales are identical, except for the fact that X affixes its valuable trademark in the controlled sales, and does not affix its trademark in uncontrolled sales. Since the effects on price of differences in intangible property associated with the sale of tangible property, such as trademarks, are normally not reasonably ascertainable, such differences would normally render the uncontrolled sales noncomparable.

Example (3). Assume that the circumstances surrounding the controlled and uncontrolled sales are identical except for the fact that X, a manufacturer of business machines, makes certain minor modifications in the physical properties of the machines to satisfy safety specifications or other specific requirements of a customer in controlled sales, and does not make these modifications in uncontrolled sales. Since minor physical differences in the product gen-

erally have a definite and reasonably ascertainable effect on prices, such differences do not normally render the uncontrolled sales noncomparable to the controlled sales.

(iii) Where there are two or more comparable uncontrolled sales susceptible of adjustment as defined in subdivision (ii) of this subparagraph, the comparable uncontrolled sale or sales requiring the fewest and simplest adjustments provided in subdivision (ii) of this subparagraph should generally be selected. Thus, for example, if a taxpayer makes comparable uncontrolled sales of a particular product which differ from the controlled sale only with respect to the terms of delivery, and makes other comparable uncontrolled sales of the product which differ from the controlled sale with respect to both terms of delivery and terms of payment, the comparable uncontrolled sales differing only with respect to terms of delivery should be selected as the comparable uncontrolled sale.

(iv) One of the circumstances which may affect the price of property is the fact that the seller may desire to make sales at less than a normal profit for the primary purpose of establishing or maintaining a market for his products. Thus, a seller may be willing to reduce the price of a product, for a time, in order to introduce his product into an area or in order to meet competition. However, controlled sales may be priced in such a manner only if such price would have been charged in an uncontrolled sale under comparable circumstances. Such fact may be demonstrated by showing that the buyer in the controlled sale made corresponding reductions in the resale price to uncontrolled purchasers, or that such buyer engaged in substantially greater sales promotion activities with respect to the prod-

uct involved in the controlled sale than with respect to other products. For example, assume X, a manufacturer of batteries, commences to sell car batteries to Y, a subsidiary of X, for resale in a new market. In its existing markets X's batteries sell to independent retailers at $20 per unit, and X sells them to wholesalers at $17 per unit. Y also sells X's batteries to independent retailers at $20 per unit. X's batteries are not known in the new market in which Y is operating. In order to engage competitively in the new market Y incurs selling and advertising costs substantially higher than those incurred for its sales of other products. Under these circumstances X may sell to Y, for a time, at less than $17 to take into account the increased selling and advertising activities of Y in penetrating and establishing the new market. This may be done even though it may result in a transfer price from X to Y which is below X's full costs of manufacturing the product.

(3) *Resale price method.* (i) Under the pricing method described as the "resale price method", the arm's length price of a controlled sale is equal to the applicable resale price (as defined in subdivision (iv) or (v) of this subparagraph), reduced by an appropriate markup, and adjusted as provided in subdivision (ix) of this subparagraph. An appropriate markup is computed by multiplying the applicable resale price by the appropriate markup percentage as defined in subdivision (vi) of this subparagraph. Thus, where one member of a group of controlled entities sells property to another member which resells the property in uncontrolled sales, if the applicable resale price of the property involved in the controlled sale is $100 and the appropriate markup percentage for resales by the buyer is 20 percent, the arm's length price of the controlled sale is

$80 ($100 minus 20 percent × $100), adjusted as provided in subdivision (ix) of this subparagraph.

(ii) The resale price method must be used to compute an arm's length price of a controlled sale if all the following circumstances exist:

(*a*) There are no comparable uncontrolled sales as defined in subparagraph (2) of this paragraph.

(*b*) An applicable resale price, as defined in subdivision (iv) or (v) of this subparagraph, is available with respect to resales made within a reasonable time before or after the time of the controlled sale.

(*c*) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by physically altering the product before resale. For this purpose packaging, repacking, labeling, or minor assembly of property does not constitute physical alteration.

(*d*) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by the use of intangible property. See § 1.482-2(d)(3) for the definition of intangible property.

(iii) Notwithstanding the fact that one or both of the requirements of subdivision (ii)(*c*) or (*d*) of this subparagraph may not be met, the resale price method may be used if such method is more feasible and is likely to result in a more accurate determination of an arm's length price than the use of the cost plus method. Thus, even though one of the requirements of such subdivision is not satisfied, the resale price method may nevertheless be more appropriate

than the cost plus method because the computations and evaluations required under the former method may be fewer and easier to make than under the latter method. In general, the resale price method is more appropriate when the functions performed by the seller are more extensive and more difficult to evaluate than the functions performed by the buyer (reseller). The principle of this subdivision may be illustrated by the following examples in each of which it is assumed that corporation X developed a valuable patent covering product M which it manufactures and sells to corporation Y in a controlled sale, and for which there is no comparable uncontrolled sale:

Example (1). Corporation Y adds a component to product M and resells the assembled product in an uncontrolled sale within a reasonable time after the controlled sale of product M. Assume further that the addition of the component added more than an insubstantial amount to the value of product M, but that Y's function in purchasing the component and assembling the product prior to sale was subject to reasonably precise valuation. Although the controlled sale and resale does not meet the requirements of subdivision (ii)(*c*) of this subparagraph, the resale price method may be used under the circumstances because that method involves computations and evaluations which are fewer and easier to make than under the cost plus method. This is because X's use of a patent may be more difficult to evaluate in determining an appropriate gross profit percentage under the cost plus method, than is evaluation of Y's assembling function in determining the appropriate markup percentage under the resale price method.

Example (2). Corporation Y resells product M in an uncontrolled sale within a reasonable time after the con-

trolled sale after attaching its valuable trademark to it. Assume further that it can be demonstrated through comparison with other uncontrolled sales of Y that the addition of Y's trademark to a product usually adds 25 percent to the markup on its sales. On the other hand, the effect of X's use of its patent is difficult to evaluate in applying the cost plus method because no reasonable standard of comparison is available. Although the controlled sale and resale does not meet the requirements of subdivision (ii) (*d*) of this subparagraph, the resale price method may be used because that method involves computations and evaluations which are fewer and easier to make than under the cost plus method. This is because, under the circumstances, X's use of a patent is more difficult to evaluate in determining an appropriate gross profit percentage under the cost plus method, than is evaluation of the use of Y's trademark in determining the appropriate markup percentage under the resale price method.

(iv) For the purposes of this subparagraph the "applicable resale price" is the price at which it is anticipated that property purchased in the controlled sale will be resold by the buyer in an uncontrolled sale. The "applicable resale price" will generally be equal to either the price at which current resales of the same property are being made or the resale price of the particular item of property involved.

(v) Where the property purchased in the controlled sale is resold in another controlled sale, the "applicable resale price" is the price at which such property is finally resold in an uncontrolled sale, providing that the series of sales as a whole meets all the requirements of subdivision (ii)

of this subparagraph or that the resale price method is used pursuant to subdivision (iii) of this subparagraph. In such case, the determination of the appropriate markup percentage shall take into account the function or functions performed by all members of the group participating in the series of sales and resales. Thus, if X sells a product to Y in a controlled sale, Y sells the product to Z in a controlled sale, and Z sells the product in an uncontrolled sale, the resale price method must be used if Y and Z together have not added more than an insubstantial amount to the value of the product through physical alteration or the application of intangible property, and the final resale occurs within a reasonable time of the sale from X to Y. In such case, the applicable resale price is the price at which Z sells the product in the uncontrolled sale, and the appropriate markup percentage shall take into account the functions performed by both Y and Z.

(vi) For the purposes of this subparagraph, the appropriate markup percentage is equal to the percentage of gross profit (expressed as a percentage of sales) earned by the buyer (reseller) or another party on the resale of property which is both purchased and resold in an uncontrolled transaction, which resale is most similar to the applicable resale of the property involved in the controlled sale. The following are the most important characteristics to be considered in determining the similarity of resales:

(*a*) The type of property involved in the sales. For example: machine tools, men's furnishings, small household appliances.

(*b*) The functions performed by the reseller with respect to the property. For example: packaging, labeling, delivering, maintenance of inventory, minor

assembly, advertising, selling at wholesale, selling at retail, billing, maintenance of accounts receivable, and servicing.

(*c*) The effect on price of any intangible property utilized by the reseller in connection with the property resold. For example: patents, trademarks, trade names.

(d) The geographic market in which the functions are performed by the reseller.

In general, the similarity to be sought relates to the probable effect upon the markup percentage of any differences in such characteristics between the uncontrolled purchases and resales on the one hand and the controlled purchases and resales on the other hand. Thus, close physical similarity of the property involved in the sales compared is not required under the resale price method since a lack of close physical similarity is not necessarily indicative of dissimilar markup percentages.

(vii) Whenever possible, markup percentages should be derived from uncontrolled purchases and resales of the buyer (reseller) involved in the controlled sale, because similar characteristics are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers. In the absence of resales by the same buyer (reseller) which meet the standards of subdivision (vi) of this subparagraph, evidence of an appropriate markup percentage may be derived from resales by other resellers selling in the same or a similar market in which the controlled buyer (reseller) is selling, providing such resellers perform comparable functions. Where the function performed by the

reseller is similar to the function performed by a sales agent which does not take title, such sales agent will be considered a reseller for the purpose of determining an appropriate markup percentage under this subparagraph and the commission earned by such sales agent, expressed as a percentage of the sales price of the goods, may constitute the appropriate markup percentage. If the controlled buyer (reseller) is located in a foreign country and information on resale by other resellers in the same foreign market is not available, then markup percentages earned by United States resellers performing comparable functions may be used. In the absence of data on markup percentages of particular sales or groups of sales, the prevailing markup percentage in the particular industry involved may be appropriate.

(viii) In calculating the markup percentage earned on uncontrolled purchases and resales, and in applying such percentage to the applicable resale price to determine the appropriate markup, the same elements which enter into the computation of the sales price and the costs of goods sold of the property involved in the comparable uncontrolled purchases and resales should enter into such computation in the case of the property involved in the controlled purchases and resales. Thus, if freight-in and packaging expense are elements of the cost of goods sold in comparable uncontrolled purchases, then such elements should also be taken into account in computing the cost of goods sold of the controlled purchase. Similarly, if the comparable markup percentage is based upon net sales (after reduction for returns and allowances) of uncontrolled resellers, such percentage must be applied to net sales of the buyer (reseller).

(ix) In determining an arm's length price appropriate adjustment must be made to reflect any material differences between the uncontrolled purchases and resales used as the basis for the calculation of the appropriate markup percentage and the resales of property involved in the controlled sale. The differences referred to in this subdivision are those differences in functions or circumstances which have a definite and reasonably ascertainable effect on price. The principles of this subdivision may be illustrated by the following example:

Example. Assume that X and Y are members of the same group of controlled entities and that Y purchases electric mixers from X and electric toasters from uncontrolled entities. Y performs substantially similar functions with respect to resales of both the mixers and the toasters, except that it does not warrant the toasters, but does provide a 90-day warranty for the mixers. Y normally earns a gross profit on toasters of 20 percent of gross selling price. The 20-percent gross profit on the resale of toasters is an appropriate markup percentage, but the price of the controlled sale computed with reference to such rate must be adjusted to reflect the difference in terms (the warranty).

(4) *Cost plus method.* (i) Under the pricing method described as the "cost plus method", the arm's length price of a controlled sale of property shall be computed by adding to the cost of producing such property (as computed in subdivision (ii) of this subparagraph), an amount which is equal to such cost multiplied by the appropriate gross profit percentage (as computed in subdivision (iii) of this subparagraph), plus or minus any adjustments as provided in subdivision (v) of this subparagraph.

(ii) For the purposes of this subparagraph, the cost of producing the property involved in the controlled sale, and the costs which enter into the computation of the appropriate gross profit percentage shall be computed in a consistent manner in accordance with sound accounting practices for allocating or apportioning costs, with neither favors nor burdens controlled sales in comparison with uncontrolled sales. Thus, if the costs used in computing the appropriate gross profit percentage are comprised of the full cost of goods sold, including direct and indirect costs, then the cost of producing the property involved in the controlled sales must be comprised of the full cost of goods sold, including direct and indirect costs. On the other hand, if the costs used in computing the appropriate gross profit percentage are comprised only of direct costs, the cost of producing the property involved in the controlled sale must be comprised only of direct costs. The term "cost of producing", as used in this subparagraph, includes the cost of acquiring property which is held for resale.

(iii) For the purposes of this subparagraph, the appropriate gross profit percentage is equal to the gross profit percentage (expressed as a percentage of cost) earned by the seller or another party on the uncontrolled sale or sales of property which are most similar to the controlled sale in question. The following are the most important characteristics to be considered in determining the similarity of the uncontrolled sale or sales:

(a) The type of property involved in the sales. For example: machine tools, men's furnishings, small household appliances.

(b) The functions performed by the seller with respect to the property sold. For example: contract

manufacturing, product assembly, selling activity, processing, servicing, delivering.

(c) The effect of any intangible property used by the seller in connection with the property sold. For example: patents, trademarks, trade names.

(d) The geographic market in which the functions are performed by the seller.

In general, the similarity to be sought relates to the probable effect upon the margin of gross profit of any differences in such characteristics between the uncontrolled sales and the controlled sale. Thus, close physical similarity of the property involved in the sales compared is not required under the cost plus method since a lack of close physical similarity is not necessarily indicative of dissimilar profit margins. See subparagraph (2)(iv) of this paragraph, relating to sales made at less than a normal profit for the primary purpose of establishing or maintaining a market.

(iv) Whenever possible, gross profit percentages should be derived from uncontrolled sales made by the seller involved in the controlled sale, because similar characteristics are more likely to be found among sales of property made by the same seller than among sales made by other sellers. In the absence of such sales, evidence of an appropriate gross profit percentage may be derived from similar uncontrolled sales by other sellers whether or not such sellers are members of the controlled group. Where the function performed by the seller is similar to the function performed by a purchasing agent which does not take title, such purchasing agent will be considered a seller for the purpose of determining an appropriate gross profit percentage under this subparagraph and the commission

earned by such purchasing agent, expressed as a percentage of the purchase price of the goods, may constitute the appropriate gross profit percentage. In the absence of data on gross profit percentages of particular sales or groups of sales which are similar to the controlled sale, the prevailing gross profit percentages in the particular industry involved may be appropriate.

(v) Where the most similar sale or sales from which the appropriate gross profit percentage is derived differ in any material respect from the controlled sale, the arm's length price which is computed by applying such percentage must be adjusted to reflect such differences to the extent such differences would warrant an adjustment of price in uncontrolled transactions. The differences referred to in this subdivision are those differences which have a definite and reasonably ascertainable effect on price. [Reg. § 1.482-2.]

In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 71-1514

SOL BERGER, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A-1 to A-6) is not yet officially reported. The opinion of the district court (Pet. App. A-10 to A-26) is reported at 325 F. Supp. 1297.

JURISDICTION

The judgment of the court of appeals (Pet. App. A-7) was entered on March 29, 1972. The petition for a writ of certiorari was filed on May 19, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

471-070—72——1

QUESTION PRESENTED

Whether there is sufficient evidence to support the finding of the district court that petitioner acted willfully with intent to defeat and evade the income tax liability of his controlled corporation in causing it to take improper tax deductions for manufacturing costs which were expenses of a wholly owned subsidiary.

STATUTES INVOLVED

26 U.S.C. 482 is set forth at Pet. App. A–29.

26 U.S.C. 7201 provides as follows:

> Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.

STATEMENT

After a bench trial in the United States District Court for the Southern District of New York, petitioner was convicted of having willfully attempted to evade income taxes owed for the years 1962, 1963 and 1964 by the Colonial Corporation of America, in violation of Section 7201 of the Internal Revenue Code of 1954 (R. 21a, 24a–25a).[1] Petitioner was sentenced to concurrent prison terms of eighteen months on each count, with the conditions that he be confined

[1] "R." references are to the appendix in the court of appeals.

in a jail-type institution for three months, that execution of the remaining prison sentence be suspended, and that he be placed on probation for a period of one year commencing upon expiration of confinement. The court of appeals affirmed (Pet. App. A–1 to A–6).

Petitioner was chief executive officer of, and a controlling shareholder in, Colonial Corporation of America ("Colonial"), a manufacturer of wearing apparel (Pet. App. A–1, A–12). In 1959, Colonial organized a foreign subsidiary, Colonial Shirts of Jamaica, Ltd. ("Jamaica") in order to take advantage of the permanent exemption which such a corporation would enjoy from United States income taxes. Jamaica manufactured shirts and sold its entire production to Colonial (Pet. App. A–2, A–12).

For purpose of the United States customs duties imposed on Jamaica's sales to Colonial, the corporations established a price equal to the shirts' "constructed value" (R. 486a–487a, 488a). See 19 U.S.C. 1401a. The price so determined was based on manufacturing costs and included an allowance of a reasonable profit to Jamaica. This price was substantiated by Colonial and approved by a United States Customs Examiner. Jamaica thereafter billed Colonial at this price (R. 569a).

The district court found that, beginning in 1959 or 1960, and at petitioner's express direction, the head bookkeeper of Colonial caused some of the invoices for piece goods shipped and invoiced to Jamaica to be entered in Colonial's purchase journals and paid by

Colonial; quarterly reports of such entries and payments were made only to petitioner. The substance of this practice was that Colonial was thereby paying a portion of Jamaica's expenses, amounting to between $50,000 and $75,000 per quarter; the effect of these payments was that Colonial claimed a business expense which in fact was attributable to Jamaica, a corporation not subject to federal income tax.

The district court accepted as true the testimony of Colonial's production chief and accountants that this practice of having Colonial make payments directly to Jamaica's suppliers was not known by or disclosed to them. The district court disbelieved the testimony of petitioner, who denied instructing the bookkeeper in this practice and testified that his fellow officers agreed to these manipulations in order to insure a "fair profit" to Jamaica (R. 1264a, 1353a; 1239). (Pet. App. A–5 to A–6, A–13, A–22 to A–26.)

These payments reduced Colonial's reported income tax liabilities in the amounts of $152,954.71, $123,065.09, and $191,417.77 for 1962, 1963 and 1964, respectively (Pet. App. A–13; R. 1815a). The district court held that these payments were not properly deductible as expenses of Colonial (Pet. App. A–18), and the court of appeals affirmed.

ARGUMENT

1. There is no merit in petitioner's contention (Pet. 5–15) that Colonial was entitled to pay, and to claim tax deductions for, Jamaica's costs by virtue of Section 482 of the Internal Revenue Code of 1954. Petitioner did not testify that he acted in good faith

reliance on Section 482, or that he was even aware of it, but claims (Pet. 8) that his shifting of purchase costs from Jamaica to Colonial was a type of reallocation of expenses which is impliedly approved as a "safe haven" by Section 1.482–1(b) of the Treasury Regulations on Income Tax, 26 C.F.R. 1.482–1(b). Thus, despite his protestations (Pet. 12–13), it is he, not the government, who relies on Section 482. However, Section 482 can be invoked only at the instance of the government; use of Section 482 is not a matter of right to taxpayer. See, *e.g., Interstate Fire Insurance Co.* v. *United States,* 215 F. Supp. 586, 598 (E.D. Tenn), affirmed, 339 F. 2d 603 (C.A. 6).

The courts below (Pet. App. A–5, A–18 to A–19) found that the expenses in question were necessary expenses of Jamaica and that their "clandestine payment" (Pet. App. A–4) by Colonial could only properly constitute a loan or capital contribution to Jamaica, rather than a deductible expense of Colonial. This conclusion is consistent with the other facts in the case. The Colonial official responsible for negotiating the "constructed value," or price, testified (R. 522a–524a) that it was based on the "exact" cost of trim and a "very accurate" cost figure for piece goods and, while taxpayer testified that he used the "smallest possible profit" figure, it was noted by the courts below that Jamaica's resultant profits, which varied from 6 to 13 percent of sales during the years in question, were not "trifling" (Pet. App. A–3, A–14). The court below properly reasoned (Pet. App. A–3 to A–4, A–17 to A–18) that these findings made distinguish-

able the unusual situation where an expenditure by a parent corporation to preserve the viability of a subsidiary has been held an ordinary and necessary expense of the parent corporation.[2] Petitioner's case is therefore governed by the rule that a parent corporation cannot ordinarily deduct expenses incurred by its subsidiary. *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590.

As held by the district court (Pet. App. A–15 to A–16) and the court of appeals (Pet. App. A–3 to A–4), the correct tax liability of Colonial was fixed by the form in which it chose to cast its transactions in the relevant tax years and it is no defense to these criminal charges that petitioner might have arranged Colonial's transactions in those years so as to achieve a lower tax for Colonial. *United States* v. *Campbell,* 351 F. 2d 336, 340 (C.A. 2), certiorari denied, 383 U.S. 907; *United States* v. *Vardine,* 305 F. 2d 60, 64 (C.A. 2); *Clark* v. *United States,* 211 F. 2d 100, 105 (C.A. 8), certiorari denied, 348 U.S. 911.

2. Petitioner's contention (Pet. 16–20) that his conduct was not motivated by a desire to avoid taxes and was not willful was properly rejected by the district court (Pet. App. A–21 to A–26) and the court of appeals (Pet. App. A–5 to A–6). Such a determination by the district court is normally sustained if it is supported by evidence which is substantial when viewed most favorably to the government. *United States* v. *Sheiner,*

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[2] Of course, if Jamaica had required additional funds this could have been achieved through an increase in the constructed value. Presumably petitioner desired to keep this price low in order to minimize the 25 percent customs duty. See Pet. App. A–16 to A–17.

410 F. 2d 337, 340 (C.A. 2), certiorari denied, 396 U.S. 825; *United States* v. *Durant*, 324 F. 2d 859, 864 (C.A. 7), certiorari denied, 377 U.S. 906. As the court of appeals correctly summarized (at Pet. App. A–6):

> The government's independent evidence of willful affirmative acts beyond its proof of understated taxes, *Spies* v. *United States*, 317 U.S. 492, 499 (1943) included the following: (1) appellant directed Colonial's bookkeeper to remove Jamaica invoices in the amount of $50,000 to $75,000 each quarter for treatment as expenses on the books of Colonial; (2) he and only he received from the bookkeeper separate records which were kept of each false entry; (3) he concealed this procedure from all other top officers of Colonial, from Colonial's accountants and from its outside auditors. Appellant's denials not having been credited by the trial court, its finding of criminal intent beyond a reasonable doubt is amply supported by the evidence.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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